INTERIM ASSESSMENT:

MUNICIPAL INFRASTRUCTURE FINANCE PROGRAM (192-HG-001)

Czech Republic

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EXECUTIVE SUMMARY

The purpose of this assessment is to provide USAID (RUDO/Warsaw) with a review of the status the Municipal Infrastructure Finance Program's (MIFP) policy objectives, and with recommendations on additional assistance to be provided under the Program. The assessment team was also asked, if appropriate, to formulate a statement of revised objectives and targets.

I. Status of MIFP Policy Objectives

In 1993, five policy objectives were established for the Program, relating to a) establishing a borrowing institution; b) demonstrating the low risk of lending to municipalities; c) increasing overall commercial lending to municipalities; d) increasing municipal capital infrastructure investment; and e) improving the quality of financial management of municipal credit, both in banks and in municipalities.

Each of these objectives are discussed in the body of the report. In summary, the team considers that the first four objectives of the Program were fully met, using the indicators established at the time the Program was designed. Progress on the fifth objective is more difficult to measure and more open to debate since it involved a qualitative assessment of the "...improvement in the budgeting and financial management capabilities of local governments (and)..in the financial appraisal of municipal loan applications by banks and other financial institutions."

Information is limited, but seems to indicate that larger cities (populations over 50,000) use appropriate financial planning techniques, while fewer medium sized municipalities (populations of 5,000 up to 50,000) have adequate financial management, and very few small municipalities (populations of less than 5,000) are familiar with these practices. The team concluded that Objective (e) was not fully met and that more work needs to be done to help smaller and medium sized municipalities.

II. The Role of the MIFP in the Emerging Municipal Credit Market and Recommendation on Refining the Program's Target Group and Objectives

Lending through MUFIS represents about 10% of total commercial long-term loans to municipalities, defined as loans over four years. Because of the lack of data on banks' portfolios, it was not possible to draw any conclusions on a causal relationship between the availability of MUFIS resources and banks lending with their own resources to municipalities. However, the MIFP does seems to have had some impact on the characteristics of the emerging municipal credit market. There seems to have been an influence on the length of loans to municipalities; some banks are now making seven to ten year loans, while several years ago, four years was the maximum term. Also, from the beginning of the Program, there seems to have been an unwritten objective to maximize the number of participating banks in order to increase competition, and to get as many smaller and medium sized municipalities to participate as possible.

While the largest municipalities in the Czech Republic have clear access to bank credit and can easily issue bonds, small and medium sized municipalities still have difficulty in gaining access to credit. The team recommends that USAID and participating institutions agree upon clearer definition of this target group of municipalities and focus the Program more specifically on assisting this group during the final phase of the Program, both for MUFIS lending and for technical assistance activity. Efforts should be made to identify the specific problems which face these municipalities, and to ensure that the Program's assistance is directed where it will have the greatest impact.

III. Risk Management and Recommended Changes in MUFIS Lending Structure

In 1993, when the Program began, MUFIS's lending rate to banks was fixed at 9.5%. The maximum lending rate by banks to municipalities was set at 12%. The MUFIS-to-bank margin included 0.25% for reserves to cover losses, including foreign exchange risk.

Until the economic crisis in the Spring of 1997, the interest rate structure of MUFIS was not an issue. MUFIS loans were slightly concessional, but quite close to commercial lending rates. However, as a result of severe economic pressures, commercial lending rates have changes significantly and the MIFP's lending structure is out of balance with the banking sector. At the time of the assessment, the best rates of the three largest banks ranged from 14.5%-15.7% and deposit rates were about 11%-13%. With a point difference of 3.5 and 5.0 between MUFIS and commercial bank lending, MUFIS lending is seen as highly subsidized. This is contrary to the purpose of the Program which is to catalyze commercial lending, not become a substitute for it.

The team recommends that USAID and MUFIS begin to work immediately on an appropriate system to adjust the lending structure, using a commercial benchmark rate against which MUFIS loans will be pegged, i.e., adjusted up or down, depending on changes in commercial rates. As part of the lending structure review, the team recommends that margins be adjusted to more fairly cover some of the foreign exchange costs of borrowing HG resources and to cover additional operational costs, as necessary.

IV. Options for Capital and Technical Assistance

USAID has approved the use of up to US$60 million in HG resources for the Czech Republic. A total of US$44 million has been obligated, including the loan which is in the process of being borrowed. The team feels that there is justification for additional HG resources to address problems which still face small and medium sized municipalities, but this will need to discussed in detail between USAID and participating institutions.

The team also believes that the Ministry of Finance and MUFIS should fully analyze the costs of borrowing externally, and compare these costs with raising resources domestically. A State guaranteed bond might provide investment capital at equivalent rates to those recommended for the HG resources (assuming an adjusted lending structure), and could cost less to the Government of the Czech Republic (GOCR) than dollar loans would.

A review of all completed technical assistance activities was not possible. In general, however, the team felt that the technical assistance program has served the Program's objectives. At the same time, additional, more focused technical assistance is needed to develop capacity within the country to provide training and assistance to municipalities and to banks, and to deal with specific problems still facing small and medium sized municipalities.

A number of technical assistance activities have been proposed which are briefly discussed in the body of the report. The team recommends that a working group be established to refocus the

Program on its specific target group and a defined set of problems, and then to review all outstanding technical assistance proposals in light of their potential impact on those revised Program objectives. A two year technical assistance work plan should be prepared, with specific results defined for the end of year two.

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Julie Otterbein and Loic Chiquier
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INTRODUCTION

The purpose of this assessment is to provide USAID (RUDO/Warsaw) with a review of progress made toward the objectives of the Municipal Infrastructure Finance Program (MIFP) and recommendations on additional assistance to be provided under the Program.

A two person assessment team was in the Czech Republic from November 10-21. Work was guided by questions in the Statement of Work (see Attachment 1), although information was not available to answer every question posed. The team interviewed representatives of institutions and organizations which have participated in the Program over the past four years. (See List of People Interviewed, Attachment 2.) The team also reviewed a large number of background documents prepared over the life of the Program, and annual reports from participating banks and other institutions. (See Documents reviewed, Attachment 3.)

The team was given excellent cooperation by participating institutions, all of whom have made important contributions to the objectives of the Program. It is clear that a great deal has been accomplished under the MIFP in a very short time. However, given the large amount of information gathered from interviews and documents, and the short exposure of the team to this complex Program, the report cannot capture all of its achievements. The team hopes, however, that the key issues for future discussion are highlighted and that any inaccuracies in the report are in details which do not affect its overall findings and recommendations for adjustments in the Program.

PART I: Assessment of the Status of MIFP Policy Objectives

The Scope of Work called for the team to review the Program's objectives and targets and, if appropriate, to formulate a statement of revised objectives and targets. The first question the team addressed was whether the Program's original policy objectives have been met. These objectives were defined in the Policy Action Plan, Annex B, of the August, 1993 "Czech Republic, Housing Guaranty HG-001 Municipal Infrastructure Finance System Program Memorandum" and were meant to support macro-level efforts by the Czech Government to create a private municipal finance system. Each objective is discussed separately below.

Objective 1: A Functioning Borrower that is financially sound and that stimulates and encourages non-governmental lending to local governments for sustainable infrastructure projects.

Status: This objective should be considered met.

Discussion: The borrower, MUFIS, a subsidiary of the Czech and Moravian Guaranty and Development Bank, is operational, making loans to banks which in turn lend resources to municipalities for infrastructure projects. As noted in the June, 1997, "Monitoring Report, Municipal Infrastructure Financing Program, Czech Republic", MUFIS did not hire all of the staff which were recommended by consultants in the past. There may be still be need to strengthen some of the oversight activities of MUFIS, particularly with regard to monitoring the financial situation of participating banks during this period of financial sector adjustment. However, it may be possible to contract for this additional work, rather than to hire new staff, especially given that the Program is in its final phase.

Objective 2: Demonstration that properly designed municipal lending involves acceptable credit and business risks and that it therefore is financially sound for banks and other private financial sector institutions to increase municipal lending from their own resources.

Status: This objective can be considered met.

Discussion: The two indicators selected for this objective relate to the percentage and value of delinquent municipal loans made under the Program. Using those indicators alone, the Program is fully successful since no delinquencies have been reported for any participating municipality, thus far.

Even though no delinquencies have been reported, three municipal borrowers have higher debt service levels that would be considered safe, well above 30%. If these municipalities were to become delinquent on MUFIS loans, it would not affect the Program's indicators,i.e., delinquencies would still be under the established targets for number and volume of delinquencies.

High debt service is a danger sign, but perhaps it is more appropriately addressed under Objective 5 which deals with improvement in bank appraisals and municipal budget planning.

Objective 3: A substantial increase in the annual levels of lending to the local government infrastructure sector from all non-governmental sources, both in absolute terms and relative to central government investment subsidies for local government investment.

Status: This objective should be considered met.

Discussion: The agreed upon indicators for this objective were that annual non-governmental lending to local authorities should exceed $20 million by the end of 1995, and that commercial-rate credit should grow faster than central government subsidies as a source of financing for local government capital spending, using 1993 as a baseline. By the end of 1995, the equivalent of more than US$125 million in long-term loans had been made to local authorities, exceeding the established indicator six-fold.

Aggregate bank lending to municipalities, both short-term and long-term, represented only CZK 900 million in 1992. The volume of commercial lending was three times that level in 1993 and doubled again in 1994. (Source: "Current Situation of Municipalities in the Czech Republic", V. Kamenickova, Ministry of Finance.) In nominal terms, between 1995 and 1997, lending to municipalities continued to increase as follows:

Commercial Loans to Local Authorities
(in CZK billions, As of September 30)

	1995	1996	Change	1997	Change
Short-term	2.6	2.5		2.7	
Long-term	3.1	5.3	+71%	7.0	+32%
Total	5.7	7.8	+37%	9.7	+24%

Source: "Current Municipal Lending Environment of Commercial Banks in the Czech Republic", F.Van Antwerp, Z. Matouskova, and G. Peterson.

There is no question that lending by commercial banks has grown faster than government subsidies to local authorities. Data from 1993-1996 show that total subsidies to municipalities from central government were in the range of CZK 28-35 billion annually, while commercial lending increased significantly.

It is unreasonable to expect that annual increases in borrowing will continue at anywhere near these levels. In fact, the central government has taken measures to curb borrowing by local authorities because of public sector deficits. Adjustments have also been made in the revenue sharing formulas (set in 1993) resulting in a further tapering off of revenues to municipalities, or slight declines, in some cases. The central government also plans to institute debt service ceilings of 20% on local government and a monitoring system to regulate future borrowing by municipalities.

Objective 4: *Demonstration of increased municipal capital investment in basic infrastructure. (The Program was also expected to encourage investment outside of Prague.)*

Status: This objective should be considered met.

Discussion: Municipal capital investment in basic infrastructure did increase, as would be expected given the large increases in long-term borrowing. The indicator for this objective, an average increase of 10 percent per annum in real investment by local government, was fully met. The following table provides data on investment expenditures for the period 1993 to 1996. However, as commercial lending tapers off, increases in investment will lessen as well.

Local Government Investment Expenditures
(in CZK billions)

1993	1994	Change	1995	Change	1996	Change
31.6	42.4	+34%	50.9	+20%	53.4	+5%

Source: Municipal Budget Survey in "Monitoring Report, Municipal Infrastructure Financing Program, Czech Republic, June 1997

MUFIS loans were all made outside of Prague, but the team does not have data which breaks down total investment by Prague/outside of Prague. It is clear, though, that infrastructure investment has increased throughout the country.

Objective 5: *Demonstration of improvement in the budgeting and financial management capabilities of local governments and in the quality of infrastructure project preparation, especially as regards market-demand and cost recovery studies. Improvement in the financial appraisal of municipal loan applications by banks and other financial institutions.*

Status: The team does not believe that this objective has been fully met. However, any precise measurement is difficult because the indicator lacked clarity.

Discussion: A great deal of technical assistance has been provided to banks on credit analysis for municipalities, and to municipalities on budget planning and project preparation. Participating banks, and some non-participating banks as well, received USAID-funded training on analysis of credit risk of municipalities. Participants who were interviewed said that the training was useful.

Anecdotal evidence indicates that bank appraisal practices for municipal credit have improved. However, since banks do not share their underwriting practices and criteria, it is not possible to assess the adequacy of these practices, nor whether standards are being uniformly applied. The team believes that the adequacy of underwriting procedures should be one of the selection criteria used by MUFIS to select participating banks.

Municipalities also received a large amount of technical assistance. Providing training and assistance for municipalities is, of course, inherently more difficult than for banks since so there are so many more municipalities than banks. Some eight to ten banks may participate in the Program, while any number of the over 6,000 municipalities in the country might have an eligible loan project. (Between 40 and 50 municipalities have already received MUFIS loans.) Also, municipalities have widely varying financial management capacity and ability to absorb and apply good budget planning and project preparation practices.

At the beginning of the Program, various participating municipalities received direct one-on-one technical assistance in preparing and package loan proposals. This intensive assistance could not be continued throughout the Program. The Program tried to reach more a larger number of municipalities by developing a computer model to help municipalities to determine debt carrying capacity. The model was tested in a number of towns and cities through the cooperation of the Union of Towns and Community's Finance Committee, revised and was given to participants at a recent conference attended by representatives of about 400 municipalities. The computer model was adapted for use by participating banks as well.

Receiving training, or computer software, does not ensure that there have been improvements in municipal budgeting procedures or bank loan appraisal procedures. Information on changes in practices is both difficult to get, and difficult to interpret. There are no clear statements of what the "best practices" for municipalities are, how much improvement is "enough", whether all borrowing municipalities should be expected to improve or even a larger number.

A survey done of municipal representatives at two conferences, in 1996 and 1997 attempted to measure whether practices had changed in terms of financial planning. (Source: "Current Municipal Practices: planning and Financing investments in Infrastructure, Results of a Survey Conducted a The Conference on financial Management and Development of Municipalities in the Czech Republic, September 1997", C. Romanik, F. Conway, October 1997.) A questionnaire was developed which was used in both years. The participants in the two conferences were not the same, so the survey identified trends rather than changes which have taken place in particular municipalities. One important indicator of good financial management is whether municipalities prepare separate operating and investment budgets. More than 80% of the representatives of the larger municipalities, with populations over 50,000, said that they prepare separate investment budgets. Only a little over half of representatives of the medium sized municipalities, with populations from 5,000 up to 50,000, said that they prepared separate investment budgets. The survey asked about many different kinds of financial management practices, for example, whether the finance officers maintain debt position indicators, carry out project feasibility analyses, and many others.

In general, larger municipalities tended to have higher levels of experience than smaller ones in monitoring and evaluating the municipality's financial condition, and as a group reported greater improvements in financial management practices between 1996 and 1997. Small and medium sized municipalities have been and remain in most need of assistance.

Given available information, the team concluded that 1) Policy Objective 5 does not appear to be fully met; b) that the Program's target group of municipalities should be more clearly delineated; and c) that more concrete indicators be established for Objective 5.

The team does not recommend carrying out an additional assessment of planning practices in municipalities which have received technical assistance. Instead, additional assistance is recommended for, among other things, strengthening in-country capacity for providing training to municipalities on a sustainable basis.

Part II: The Development of the Municipal Credit Market and the Role of the MIFP

The team was asked to assess more globally the impact of the MIFP on the establishment of a municipal credit market. The questions posed in the Statement of Work were:

> "To what extent have the HG resources been responsible for progress in meeting the policy objectives? Has the Program succeeded in increasing the availability of capital for municipal finance? Are there other sources of capital that should be tapped?"

A. Changes in Bank Lending to Municipalities and Emergence of other Domestic Sources of Finance

The lending and technical assistance components of the MIFP were meant to support national objectives of the Czech government. Actions taken by the government had the largest impact on the emergence of private municipal finance, perhaps the most significant being the 1993 law reforming local budgets.

The 1993 law gave municipalities a much larger share of revenues from personal income tax. Wages increased significantly after 1993 which, in turn, increased income taxes and significantly increased annual revenues for local government. Total tax revenues increased by 52% between 1993 and 1995. Transfers from Central Government stayed about the same in nominal terms during the period, so total disposable local government revenue increased by 42%. (Source: "Current situation of Municipalities in the Czech Republic", V. Kamenickova, P. 22.)

As incomes rose, municipalities began to borrow for much needed infrastructure. As noted in the discussion of Policy Objective 3, aggregate bank lending to municipalities represented only CZK 900 million in 1992 and grew to CZK 9.7 billion in 1997. A number of commercial banks are making loans to municipalities today, while prior to 1992, the only bank which was solidly in the municipal credit market was the Czech Savings Bank which is partially owned (20%) by municipalities. Currently, several banks seem to see municipal lending and other business generated by municipalities, such as handling deposits, as part of their overall business strategies. Banks consider municipal lending less risky, than loans to business clients, but also less profitable. Commercial loans are the most important source of investment capital for municipalities at this time.

Issuing bonds directly is an alternative source of capital, but not yet as important as it might become some time in the future. Since 1992, eighteen municipal bonds have been issued, most by larger municipalities with populations over 100,000, but some by small town and medium sized cities as well. **? Several years ago, two towns, with populations of just 3,400 and 1,700 respectively, issued bonds.?** Two cities, Ostrava and Prague, have issued international bonds.

Data from Urban Research indicates that the volume of municipal bonds was just 1.2% of total bond volume in 1997. The Central government relies much more on bonds, with 34.3% of total volume, as well as banks and corporations, which issued 39.8% and 24.7% of total volume respectively. In the past, banks, insurance companies and investment funds have been the principal buyers of municipal bonds. As of July, 1997, pension funds are also permitted to invest in municipal bonds which could increase demand. A secondary market has not yet developed for bonds. However, with increased volume, a secondary market could develop over the medium term (5-10 years) which would stimulate more interest in this tool for infrastructure investment. (Source: Z. Matouškova, P. Taj_man and G. Peterson, The Secondary Municipal Bond Market within the Context of Secondary Markets in the Czech Republic, November, 1996.)

B. The Role of the MIFP in the Emerging Municipal Credit Market

A total of US$34 million in HG resources have been borrowed since the Program began. These resources are expected to be fully disbursed by the end of January, 1998. An additional loan of US$10 million is being borrowed at this time.

Lending through MUFIS represents about 10% of total commercial long-term loans to municipalities, defined as loans over four years. Determining whether there might be a cause-effect relationship between the availability of MUFIS resources and banks lending with their own resources is extremely difficult. To more clearly establish a link, data from each participating bank on long-term lending, broken down by MUFIS/Own Source funds is needed. Since banks consider this data to be confidential, it was not available to the team.

While it is difficult to make a link with total volume of lending to municipalities, the MIFP does seems to have had some impact on the characteristics of the emerging municipal credit market. The MIFP probably contributed to the lengthening of loan terms. At the beginning of the Program, few four year loans were made. Presently, some commercial loans are being made with terms of seven to ten years which is a significant change in the market. Many people attribute this change, in part, to the presence of MUFIS resources in the market. Also since the beginning of the Program, there was an unwritten objective to maximize the number of participating banks in order to increase competition.

Four banks participated at the beginning of the Program; two are inactive at this time. An additional six banks have become active or eligible to participate, and one international bank is in the process of discussing and negotiating a Master Agreement with MUFIS. See table below.

The current number of participating banks seems adequate. The larger national banks participate, and some smaller ones as well. The Savings Bank (CS) no longer has an almost exclusive position in this market. Some banks may lend only regionally, or target segments of the municipal market, particularly larger cities. Others might see the whole municipal credit market as a good source of business in the future. **There is interest of two international banks participate, one has signed a Master Agreement with MUFIS, and one is in the process of negotiating a Master Agreement with MUFIS.**

Participating Banks	Share of Disbursed & Proposed HG funds*	MUFIS status
Coop banka	14%	Suspended**
Pragobanka	12%	Suspended**
Komercni banka (KB)	29%	Active
Investicni a Postovni banka (IBP)	15%	Active
Agrobanka	7%	Active

Ceska sporitelna (CS)	7%	Active
Union banka	4%	Active
Moravia Banka	3%	Active
Ceskoslovenska obchodni banka(CSOB)	6%	Eligible
Prvni mestska banka (PMB)	3%	Eligible
Sparkasse Muhlviertler - West		**Eligible**
Waldviertler Sparkasse		**In negotiation**

*Based on completed and proposed disbursements of the first $34 million and estimated disbursements for about 50% of the new HG loans of US$10 million.

**Coop banka is being supervised directly by the Czech National Bank (CNB), and Pragobanka is under a CNB liquidity program.

At this time, more attention should be given to ensuring that banks lend their own resources to municipalities. One bank indicated that it did not plan to lend any of its resources to municipalities, which does not support the Program's objectives. MUFIS should require banks to provide information both on their past lending and on their future plans for lending to municipalities. This would allow MUFIS to select only banks which make a commitment to the sector. It would also allow better monitoring of municipal lending by participating banks. This information could remain confidential.

To the extent possible, the MIFP should also support the development of the bond market for municipalities. This would create even more competition within the market. Also, compared with bank loans, bonds are more transparent since municipalities need to obtain permits from the Ministry of Finance to issue bonds and therefore information on bonds is in the public domain. Another advantage from the perspective of municipalities is that there are fewer restrictions on general revenue bonds than on loans.

C. Sustainability of the Municipal Credit Market, and Factors which could Influence the Market

In the time remaining, it is recommend that efforts be concentrated on expanding the number of municipalities participating in the Program. The MUFIS program probably has widened the number of small and medium sized municipalities which have obtained commercial credit, but many more need to develop relationships with banks and to gain experience managing loan portfolios.

Many of the developments in the municipal credit market seem to be sustainable, at least for the largest municipalities. The biggest 20-30 municipalities will continue to borrow, to issue bonds, and to invest in infrastructure. While the flow of credit to large municipalities may be affected somewhat by fluctuations in the credit market, smaller ones are much more vulnerable. They are less able to manage their budgets, less likely to develop their own tax base, less able to negotiate terms with banks, and more likely to affected by higher debt service and difficulties in payment and credit worthiness. it is also costlier to banks to process loans for small and medium sized municipalities, and this is the group that is more likely to be dropped as bank clients if there is a credit squeeze.

1. Limits on Municipal Revenue Generation

Because the 1993 law was viewed as favoring local government over Central Government in income sharing, adjustments were made in 1996 which resulted in a tapering off of revenues to municipalities, and even a slight decline in some of the larger ones.

Central government sets tax rates, collects taxes and determines the share of revenues that municipalities will receive. In fact, municipalities have little control over income while they have almost total independence by law to incur debt. This was described in one report as follows:

> "...there is significant discord between the competence of municipalities on the side of expense (deciding on almost 90% of expenses is fully within the discretion of the given municipality), and the competence of municipalities on the income side of their budgets--almost 70% of income of municipal budgets is beyond the decision-making authority of municipalities. Such discord can be solved only be means of local tax, where the representatives of municipalities would have the authority to specify their own rates." (V. Kamenickova, op. cit, p.17)

Periodic changes in revenue sharing arrangements can have major impact on recurrent revenues. This, in turn, can materially impact projected income and capital investment plans. If local government could increase the income it generates locally, it would be less vulnerable to changes made at the national level. It is clear that greater parity is needed between local autonomy on income and expenditures if local government is to plan responsibly for capital investments.

Locally collected fees and taxes are still negligible. There is, however, at least one initiative which could increase locally generated revenues. A new law is proposed which would convert real estate tax, currently calculated on a square meter basis, to a tax based on assessed value. If passed, this could become a significant source of income since 100% of this tax passes to local government.

Another area with great room for improvement is project cost recovery. Currently many of the projects carried out under MUFIS have low cost recovery (estimated at less than 25% for all loans). Service fees for water supply and waste water projects are usually not within the control of the municipality. One local official suggested that a sports stadium could be self-supporting, but that water and sewerage projects cannot because they are managed by public companies which do not always collect full costs for services. It was suggested that direct foreign investment in these projects, presumably in the form of a Build-Own-Operate schemes, might provide a way to achieve greater cost recovery.

2. Limits on Municipal Borrowing

Because of the very steep growth in municipal borrowing, and because of large current public sector deficits (national and local), the Central government recently took measures to curb borrowing by local authorities. (It was noted during the assessment that accounting procedures for local government budgets may exaggerate current the account deficits of municipalities.) A moratorium was instituted on the issuance of bonds by local government.

The team agrees with the characterization by the Urban Institute that this prohibition is "a very cumbersome and inefficient way to restrain local government borrowing" and that it puts cities, particularly the larger ones, at a disadvantage in finding the lowest cost capital for their projects". It is hoped the moratorium on municipal bonds will be lifted shortly, and that there will be no further need for this kind of measure.

A more important control on borrowing will be put into place with a new regulatory framework for municipal budgets which is expected to be passed in 1998. The draft law calls for limits on debt service of 20% which is a reasonable debt ceiling. A functioning regulatory framework should allow greater freedom to municipalities within established parameters and could mean less intervention by central government and greater transparency in local government finance.

3. Distortions from Subsidized Lending

Many observers have warned of potential disruption for the municipal credit market arising from the operations such as the State Environment Fund (SEF). The SEF is quite independent with resources coming from fees and fines on polluting industry rather than from central government transfers. It is regulated by the Ministry of Environment, not the Ministry of Finance.

Zero interest loans were made between 1991 and the end of 1995, with a grace period on principal of up to ten years. Three-fourths of the Environment Fund's program has been directed at municipalities which puts it potentially in the same market as MUFIS and other bank lending to municipalities. Concern has been expressed that a number of loans will come due soon as grace periods on principal end. Since many of these loans were not made with solid underwriting, a rash of non-performing loans could affect the credit of those municipalities, and possibly have a spill over effect on similar sized municipalities. Therefore, SEF loans should be closely monitored.

New management at the Fund have plans to greatly expand SEF operations. It is not clear whether there would also be a greater degree of risk management and integration into the financial system. The new director of SEF ordered a detailed audit of the entire portfolio. If these results are made available outside the Fund, there may be an opportunity to influence how the Fund's activity could be more fully integrated into the municipal credit system.

The Fund charges a nominal interest rate (3%), and has begun working with commercial banks to provide a subsidy on interest rates for loans made to municipalities. Combined bank/SEF loans could total 800 million CZK which represents a significant level of financing. Joint efforts with banks might improve underwriting of loans, but these procedures should be closely monitored, at least in municipalities receiving MUFIS loans.

PART III: Program Implementation Issues and Recommendations

A. Need to Focus on Target Group and Refine Objectives

In the view of some observers, the objectives of the Program have been met and there is no further need for capital assistance. However, it is also possible to argue that the Program's principal contributions have been in broadening and deepening the market and that the access of smaller and medium sized municipalities to the credit market remains an issue.

The total number of municipalities in the Czech Republic exceeds 6,000, most of which are very small, rural towns. Two-thirds of the total population of the country lives in 267 municipalities which have populations over 5,000. See table below.

Czech Municipalities

Municipality	Population	No.municipalitis	% Population
Large	50,000+	24	34.6
Medium	5000-49,999	243	29.8
Small	up to 4,999	5,965	35.4

Since larger municipalities have good access to both commercial loans and to bonds, additional MUFIS loans probably should not be made available to this group. Instead, the Program should more explicitly target medium and small municipalities since this is the group which still has problems accessing credit. In additional to greater selectivity in MUFIS loan approvals, consideration should be given to allowing only one MUFIS loan per municipality, in order to maximize the Program's coverage.

The team recommends that a Working Group be established which looks at the obstacles to credit for the target group, and focuses the activities under the technical assistance program and MUFIS lending to this target group. The team also recommends that Objective 5 be revised, or a new objective 6 be established reflecting this focus.

B. Need to Adjust MUFIS Lending Structure to Allow Greater Flexibility to Manage Risk

Until the economic crisis in the first half of 1997, the interest rate structure of MUFIS, in the context of the overall credit market, was not seen as an issue. No one foresaw the rapid devaluation of the currency nor the spike in domestic interest rates which suddenly created a disparity between MUFIS lending rates and commercial bank lending.

At the beginning of the program, the MUFIS lending rate to banks was fixed at 9.5%. The maximum lending rate by banks to municipalities was set at 12%. The MUFIS-to-bank margin included 0.25% for reserves to cover losses, including foreign exchange risk. Although fixed rates were established, they can be adjusted at any time via a Program Implementation Letter, without amending the Program Agreement. Because of the changes in the Czech Republic's economic circumstances, this is an appropriate time to make an adjustment in the lending structure of the Program.

A November 1997 assessment of "Current Municipal Lending Environment of Commercial Banks in the Czech Republic" noted that the lending rates were more than 14%, on average, during 1997, with some considerably higher spikes during the year. At the time of the assessment, the best rates of the three largest banks were variable, and ranged from 14.5%-15.7%. Deposit rates were about 11%-13%. With a point difference of 3.5 to 5.0, the MUFIS lending structure is significantly out of balance with commercial lending.

Early in Program implementation, MUFIS lending was only slightly concessional. Currently, MUFIS lending is seen by both banks and municipalities as subsidized. As a result, demand for MUFIS loans has increased sharply and there may be instances where municipalities and banks defer lending from banks resources to try to maximize use of MUFIS loans. This is distortionary, and not compatible with the purpose of the Program, which was to catalyze lending from other resources.

The team recommends that USAID and MUFIS begin to work immediately on an appropriate system to adjust the lending structure. The representative of the Ministry of Finance and MUFIS staff agreed that a change in the Program's interest rate structure would be appropriate at this time. Preferably, this first adjustment would affect loans made with the HG resources currently being borrowed, as well as any new tranche of HG funds, and reflows.

The team recommends that a commercial benchmark rate be chosen against which MUFIS loans will be pegged, i.e., adjusted up or down, depending on changes in the commercial rates. For example, MUFIS rates could be pegged to the Pribor rate in such a way that the on lending rate under MUFIS would be about one point below commercial lending. With a slight interest rate advantage, and the longer loan terms, MUFIS loans would still be desirable, without being quite as subsidized as they are at this moment.

As part of the lending structure review, the team recommends that margins be adjusted to more fairly cover some of the foreign exchange costs of borrowing HG resources and to cover additional operational costs, as necessary. The foreign exchange risk has caused the greatest concern in recent months. When the Program was designed, no one could foresee the sharp devaluation of the Czech Crown in 1997. With devaluation, the cost of servicing dollar denominated loans has increased. One estimate, from the June 1997 Monitoring Report (p.iv), places the real cost of HG resources at over 16% after taking into account currency fluctuations. Even with favorable economic scenarios for the future, the foreign exchange losses on the first tranche of HG resources will be considerable.

To mitigate future foreign exchange losses, the team recommends that the foreign exchange reserve fund be increased through fees of between 1-1.5% as opposed to the current .25%. (Note: Annex A of the Program Summary discussed an Exchange Rate Fluctuation Fund of up to .5% so it is recommended that an even higher level be established for foreign exchange risk.)

The team also recommends that consideration be given to using indexed adjustable loans to municipalities. Banks current adjust their commercial loans to municipalities, but the basis for adjusting loan payments is not totally clear. Introducing a transparent form of variable rate loan would contribute to the development of the municipal credit market.

C. Options for Capital Assistance

USAID has approved the use of up to US$60 million in HG resources for the Czech Republic. A total of US$44 million has been obligated, including the loan which is in the process of being borrowed. The team feels that there is justification for additional HG resources, in addition to technical assistance, to address problems which still face small and medium sized municipalities. However, an agreement would need to be reached between USAID and counterpart organizations that additional capital for lending is warranted.

Another proposal has been made which should be looked at carefully which is to lend MUFIS resources for the rehabilitation of municipal apartment buildings. Municipalities have many properties which badly need renovation, and these projects could potentially have full cost recovery. The team believes that USAID and MUFIS should discuss this further to determine a) the feasibility of full cost recovery; b) if shorter loan terms and even higher interest rates might be possible; and c) if it is likely that banks would finance such projects with their own resources if a successful demonstration projects were to be carried out.

As part of the discussion of borrowing additional HG resources, the team recommends that the Ministry of Finance and MUFIS should fully analyze the costs of borrowing externally, and compare these costs with raising resources domestically. A State guaranteed bond might provide investment capital at equivalent rates to those recommended for the HG resources (assuming an adjusted lending structured), and could cost less to the GOCR than dollar loans would.

The future role of MUFIS should be discussed as part of the discussions on continued capital resources for on-lending. In 1993, GOCR considered and rejected establishing a permanent lending institution for municipalities. At this time, however, options are under consideration which might extend the life of MUFIS beyond the HG loan portfolio. One proposal was to blend MUFIS resources with government transfers (from the Ministry of Local Development), or to use these resources to guaranty loans in order to reach smaller municipalities. This could lead to a more permanent municipal lending institution. The team would like to note that world-wide, municipal lending institutions have been less efficient than the private sector in mobilizing capital for infrastructure investment.

D. Technical Assistance Activities

The team was asked to review the approved technical assistance strategies, plans and their results, summarize them, and to make recommendations about additional technical assistance. A review of every technical assistance activity carried out over the past four years was not possible since reports on completed activities were not available in the Czech Republic. Presumably this information can be found in the RUDO files in Warsaw and in the Urban Institute.

In every interview, the team asked about past and proposed technical assistance. Participating institutions were uniformly positive about technical assistance received. Representatives of banks were grateful for the access to information on measuring municipal credit risk and for the discussions and networking which took place at seminars and conferences.   A great many municipalities received technical assistance, either directly, or by participating in seminars and conferences. The largest municipalities have absorbed information and used it. For example, after representatives of one city were introduced to loan auctioning on a study tour to the U.S., they set up their own loan auction. The largest municipalities seem to be following appropriate financial planning practices, such as preparing separate operating and investment budgets, perhaps because of technical assistance. Some medium sized and smaller municipalities are also better prepared as a result of technical assistance.

The team feels that technical assistance activities have supported the Program's policy objectives, but that additional technical assistance is needed to support a more focused effort to develop capacity within the Czech Republic to provide training and assistance to municipalities and banks, and to deal with specific problems still facing small and medium sized municipalities.

A number of technical assistance activities have been proposed. Some of these proposals have been characterized as "commitments", and are listed below. Once discussions are completed on refining the target group and objectives of the final phase of the Program, all proposals for technical assistance activity should be reviewed in light of their potential impact on those revised objectives. A two year work plan should be prepared, with specific results defined for the end of year two.

The team does not feel that we had enough information and background to recommend approval or disapproval of any particular proposal. There were, however, a number of additional proposals from participating institutions, and no clear consensus on the importance of some of the activities listed above. The proposed activities with the largest estimated costs, e.g., work on indicators, updating the computer model, and others, should be carefully reviewed, since other activities may be more appropriate for the final phase of the Program. Also, greater efforts made to cost-share with Czech institutions and other donors.

Some notes on proposed activities are provided below.

1. Institutionalization of bank training

   Two rounds of training has been provided to all interested commercial banks over the past three years. There is a recommended effort to prepare case study material and to do training of trainers to institutionalize bank training within the Banking Institute. There is also interest in a more advanced course on this subject.

   The institutionalization of training should be of very high priority, particularly sustainable, i.e., fee based, which the Banking Institute is well equipped to provide. However, this work should not focus just on banks, since training for municipalities is also extremely important. The Banking Institute is a solid partner in providing training to banks and with little additional help, they should be able to build municipal credit analysis training for banks into their regular curriculum. They also indicated that it would be possible to change the course for a municipal audience, i.e., a course on "what banks require to approve loans for municipalities." Another possible training partner for municipalities is the Training Foundation, which provides a number of course for municipalities.

2. Work on the computer model and completion of the municipal finance indicators project

The computerized model for credit analysis, which was developed under the Program, has been given to all banks and municipalities participating in seminars and conferences. There is a proposal to update this model again, to reflect the changes in the expenditure and revenue line items made in 1997.

The computer model is currently a stand-alone model. The banks interviewed by the team do not use the model, and it is not clear that it is used regularly by even large cities. The model has also been given to consulting companies, and one of these companies which sells software for accounting to municipalities, has indicated that it would like to incorporate the computer model into its software. Therefore, it seems appropriate to ask whether additional work on updating the model should be done by the Program, or by the private sector which supplies accounting software.

A pilot project on indicators was carried out for one district, covering 150 municipalities. There is a proposal to expand this work. Some questions which surfaced were: How does this activity fit with the proposed credit rating system for municipalities? Will the information be in the public domain? (This is a decision which has been pending within the Ministry of Finance for some time) and who will do this work on a regular basis after technical assistance ends. Quite a lot of technical assistance funding is proposed for this activity and without clear answer to these questions, it is difficult to justify these resources.

3. Developing general purpose municipal financial statements

This activity was not discussed while the team was in country, so it is not clear what views are held on it. The proposal is to develop a reporting format for municipalities to provide information to the Ministry of Finance which would facilitate analysis of credit worthiness.

4. Project financing conference

A seminar or conference on how to meet the capital needs of small municipalities is proposed. There are several offers of assistance in providing this seminar, so it is possible that USAID technical assistance funding can be minimized.

5. Assistance to MUFIS on borrowing

Assistance has been provided to MUFIS for previous HG loan borrowing, and additional assistance is proposed for the next tranche of funds.

6. Investment pool paper

A paper will be prepared for the seminar mentioned above, on loan pools. About 100 associations of municipalities have formed in the past, some for the purposes of constructing water and sewerage systems. The paper will describe how loan pools work in other countries.

7. Program monitoring

The Program has borne much of the cost of preparing quarterly and annual monitoring reports. If staff from MUFIS and Urban Research take on more of the responsibility for these reports, the costs should decrease.

8. Participation of TA team (and USAID) in dialogue over central government regulation and monitoring of local government debt.

A critical juncture is being reached as the government begins to put into place a system which would regulate municipal budgets by establishing ceilings on borrowing. A 20 percent debt service ratio is proposed as the key indicator. It is important that this framework also allow greater freedom from central government intervention, by establishing parameters for municipalities.

9. Assistance in the development of a credit rating system for municipalities.

This proposal, described by F. Van Antwerp, has some backers although it is not clear that demand from municipalities for this service has yet emerged since credit ratings are not needed for issuing domestic bonds.

10. Assistance on real estate and V.A.T. tax changes which would expand own-source revenue of municipalities

Since municipalities have very little control over the income side of the debt equation, the proposal to base the real estate tax on value rather than square meters could substantially affect the income of municipalities in the future.

11. Project finance and cost-recovery

Since MUFIS loans recover only about 25% of costs from the projects, themselves, this is an area where assistance could be provided. Curriculum on project analysis from other training programs in Poland and elsewhere (e.g., LEM in Poland), might be useful for the Czech Republic. Also, as appropriate, exposure to BOO/BOOT models with full cost recovery.

12. Assistance in forming an informal group of financial officers

There was some sentiment among local government officials that municipalities need a greater voice to influence decisions of central government which affect their ability to manage their budgets. It was felt that financial managers of municipalities should play a greater role in this dialogue with central government.

Helping to form a group of financial officers could also provide a way for finance officers of larger municipalities to help colleagues in medium sized ones, through mentoring and internships.

PART IV: Principal Lessons Learned

The Scope of Work asked "What are the principal lessons learned from the MIFP...for the Czech Republic and other ENI countries?"

1. Building a municipal credit system needs strategic leadership from government authorities responsible for strategic financial planning

   The MIFP was successful because it built upon the vision of the GOCR, particularly the Ministry of Finance, for establishing a municipal credit market. Often urban infrastructure programs are designed and support Ministries which do not have broad responsibilities for nor understanding of capital and credit markets.

2. Broad based efforts to support development of a municipal credit market may be appropriate at the beginning of a Program, but targeting of technical and capital assistance is important as a Program progresses in order to maximize the "value added" of assistance.

   Programs need an internal mechanism of some kind to adjust the assistance program. In USAID's reegineering terms, "results package teams" are meant to carry out these reviews and adjustments.

3. Flexibility should be built into any loan program structures from the beginning so that terms and conditions of loans can be adjusted to economic circumstances.

Attachment 1

Statement of Work

Attachment 2

List of People Interviewed

Urban Research:
Petr Tajcman, Zdenka Matouskova, Hana Zelenkova

Ministry of Finance:
Vera Kamenickova, Director of Local Budget Department, Ministry of Finance

MUFIS/CMGDB:
Ladislav Macka, Chairman of the Executive Board
Josef Vanik, Chairman of the Board of Director

Union of Towns and Communities of the Czech Republic:
Vera Jechová, UTC Executive Director
Jaromír Jech, UTC Financial Commision
Ivan Cerny, UTC Financial Commision

Magistrate of the City of Pardubice:
Vladimir Jezek, Finance Director

Ministry for Local Development:
Jiri Perka, Head of Public Administration Sub-Department

Banking Institute:
Josef Janca, Head of Education Department
Sarka Bezdickova, Project Manager

State Environmental Fund:
Milos Rybicka, Economic Deputy Director

Moravia Banka, Ostrava:
Jan Rainis, Director of Department

Komercní banka, Prague:
Lubos Louda, Director of Trade Policy Department
Ivan Kuba, Trade Policy Department

Ceska sporitelna, Prague:
Petr Klos, Head of Communal Services Department
Ludmila Nalevkova, Communal Services Department

Investicní a Postovní banka:
Bohumil Pilar, Director of Corporate and Private Business Department
Ludmila Gabrielova, Credit Metodologist
Hana Rousova, Trade Department

Final Briefings for MUFIS, UTC, MOF
U.S. Embassy, John Beyerle
USAID, Rebecca Black, Michael Lee

Attachment 3

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